

Office of Chief Counsel
Internal Revenue Service

memorandum

CC: [REDACTED]: TL-N-543-00
[REDACTED]

date: **APR 27 2000**

to: [REDACTED] Case Manager, Examination Division, [REDACTED]
[REDACTED] Revenue Agent, Examination Division, [REDACTED]

from: [REDACTED] Attorney
[REDACTED] Assistant District Counsel
[REDACTED]

subject: [REDACTED]; TIN: [REDACTED]
Commission Income Accrual
Income Taxes, Year Ended [REDACTED]

DISCLOSURE STATEMENT

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This is in response to your request dated January 18, 2000, for our advice concerning the reporting by [REDACTED] of real estate sales commissions earned.

ISSUES

Whether an accrual basis real estate brokerage must recognize commission income in the period when it produces a prospective buyer who offers to purchase its customer's property on terms acceptable to the customer? If so, whether the

brokerage is entitled to reduce its commission income reported by creating an allowance for uncollectible commissions based on customers' escrows receivable that are still open at the end of the Taxpayer's fiscal year because (based on historical data maintained by the Taxpayer) a percentage of the brokerage's sale transactions are not expected to close as completed sales from escrow?

CONCLUSION

For the reasons set forth below, it is our opinion that:

1. Yes, the real estate brokerage must recognize commission income in the period when it produces a prospective buyer who offers to purchase its customer's property on terms acceptable to the customer.
2. No, the brokerage is not entitled to reduce its commission income reported by creating an allowance for uncollectible commissions based on customers' escrows receivable that are still open at the end of its fiscal year because (based on historical data) a percentage of the brokerage's transactions are not expected to close as completed sales from escrow.

FACTS¹

[REDACTED] ([REDACTED]) is the common parent of an affiliated group of corporations that filed a consolidated income tax return for the year ended [REDACTED]. Several of its affiliates provide services in the real estate field.

One of [REDACTED]'s subsidiaries, [REDACTED] (hereinafter "[REDACTED]"), is a [REDACTED] real estate brokerage. For the year ended [REDACTED], [REDACTED] used the accrual method of accounting for both book and tax purposes. [REDACTED] currently has no evidence available to prove that it elected to use the nonaccrual-experience method of accounting.

¹ Our understanding of the facts of this case is limited to the facts you have provided us. We have not undertaken any independent investigation of the facts of this case. If the actual facts were to be different from the facts known to us, our legal analysis and our conclusions and recommendations might be different. Accordingly, if you learn that the facts known to us are incorrect or incomplete in any material respect, you should not rely on the opinions set forth in this memorandum, and should contact our office immediately.

[REDACTED] accrues commission income and related expenses when escrow opens with respect to a pending real estate sale. However, at the end of the year, [REDACTED] accrues an allowance for estimated uncollectible commission income for transactions not expected to be closed as a completed sale from escrow. Exam is proposing disallowing this allowance on the basis that under I.R.C. § 451, the commission income is to be included in income under the accrual method of accounting when escrow is opened for a pending real estate sale.

On its books, [REDACTED] accounted for its sales in the following manner. At the time escrow instructions were agreed to for a listed home, the full amount of the commission due from the escrow company upon close of escrow was debited to [REDACTED]'s Commissions Receivable account, and the amount payable to the sales agent was credited to its Commissions Payable account. The difference between these two amounts was credited to a "[REDACTED]" account, which represents [REDACTED]'s revenue. When [REDACTED]'s commission was received from escrow, the full amount received was debited to its Cash account and credited to its Commissions Receivable Account. Upon paying the sales agent, [REDACTED] debited its Commissions Payable account for the amount paid and credited its Cash account for the same amount.

On its books, [REDACTED] accounted for escrows that might not close by recording "[a]t year-end an allowance for uncollectible commission income . . . as well as a correlated allowance for accrued expenses not expected to be paid. These allowances are calculated at approximately [REDACTED]% of the year end accrual balances, which is based on [REDACTED]'s historical experience of open transactions that ultimately fall out of escrow." The balances of the allowances as of [REDACTED] were as follows:

Allowance for uncollectible commissions	(\$ [REDACTED])
Allowance for commissions payables	[REDACTED]
"Net accrued commission"	(\$ [REDACTED])

In a Form 5701 dated [REDACTED], the Service has proposed increasing the gross income of [REDACTED] by the \$[REDACTED] of Net accrued commission for the fiscal year ended [REDACTED]. In the Form 5701, the Service relies heavily on Charles Schwab Corp. v. Commissioner, 107 T.C. 282 (1996), aff'd 161 F.3d 1231 (9th Cir. 1998), cert. denied U.S. [REDACTED], 120 S. Ct. 67 (1999), in which the Tax Court held that an accrual-basis securities broker had to accrue commission income from customers' purchases or sales of securities on the trade date as opposed to the settlement date, since post-trade activities conducted by the broker are ministerial acts that

constitute conditions subsequent to the customer's obligation to pay.

In rebuttal to the aforesaid Form 5701 issued by the Service, [REDACTED]'s representatives argue that the "all events test" is not met when escrows are opened. The representatives state that [REDACTED]'s contracts with home sellers set forth when [REDACTED] has the right to receive income, i.e., "[o]n recordation of the deed or other evidence of title" which does not occur until the escrows have closed.

The document which indicates that a real estate broker shall be paid compensation for services "[o]n recordation of the deed or other evidence of title" is a "Residential Purchase Agreement (and Receipt for Deposit)." This document is used for a prospective buyer to make an offer to purchase a single family residential property. A seller who wishes to accept an offer to purchase made in a "Residential Purchase Agreement (and Receipt for Deposit)" must sign a paragraph of the document captioned "Acceptance of Offer." The purchase agreement is between the prospective buyer and the seller; brokers are not a party to the agreement, which states in paragraph 31:

BROKER COMPENSATION: Seller agrees to pay compensation for services as follows:

_____, to _____, Broker, and
_____, to _____, Broker,
payable: (a) On recordation of the deed or other
evidence of title; or (b) If completion of sale is
prevented by default of Seller, upon Seller's default;
or, (c) if completion of sale is prevented by default
of Buyer, only if and when seller collects damages from
Buyer

The standard "Exclusive Agency Authorization and Right To Sell" agreement published and distributed by Real Estate Business Services, Inc., a subsidiary of the California Association of Realtors is used when a "Seller" employs a real estate broker in California and grants the broker the "exclusive and irrevocable agency right" to sell a specified property. In the "Exclusive Agency Authorization and Right to Sell," the "Seller" agrees to pay the "Broker" compensation (in paragraph 5) as follows:

- A. 1. If Broker or any other broker or agent produces a buyer(s) who offers to purchase the Property on the . . . price and terms [stated in the agreement], or on any price and terms acceptable to Seller during the Listing Period, or any extension;

2. If within _____ calendar days after expiration of the Listing Period or any extension, the Property is sold, conveyed, leased or otherwise transferred to anyone with whom Broker or a cooperating broker has had negotiations, provided that Broker gives Seller, prior to or within **5 calendar days** after expiration of the Listing Period or any extension, a written notice with the names of the prospective purchaser(s);

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- B. If completion of the sale is prevented by a party to the transaction other than the Seller, then compensation due under paragraph 5A shall be payable only if and when Seller collects damages by suit, settlement, or otherwise, and then in an amount equal to the lesser of one-half of the damages recovered or the above compensation, after first deducting title and escrow expenses and the expenses of collection, if any.

DISCUSSION

I.R.C. § 451(a) provides that the amount of any item of gross income shall be included in gross income for the taxable year received by the taxpayer, unless under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

Treas. Reg. § 1.451-1(a) provides, in part, that under an accrual method of accounting, income is includible in gross income when all events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. All the events that fix the right to receive income occur when (1) the required performance takes place, (2) payment is due, or (3) payment is made, whichever happens first. See Schlude v. Commissioner, 372 U.S. 128 (1963). It is the right to receive payment, not the actual receipt, that determines whether income has accrued and must be included in the gross income of an accrual basis taxpayer. Commissioner v. Hansen, 360 U.S. 446 (1959); Spring City Foundry Co. v. Commissioner, 292 U.S. 182, 184 (1934).

In the instant case, it is clear from the standard "Exclusive Agency Authorization and Right To Sell" agreement that the services for which commissions were earned by [REDACTED] were performed by [REDACTED] when it produced buyers who offered to purchase properties at terms acceptable to its

customers. Accordingly, all the events occurred which fixed the right of [REDACTED] to receive commission income and [REDACTED] must accrue its commission income at such time.

Section 448(d)(5) of the Code provides that any person using an accrual method of accounting with respect to amounts to be received for the performance of services by such person shall not be required to accrue any portion of such amounts which (on the basis of experience) will not be collected (the "nonaccrual-experience method"). The provisions of section 448(d)(5) do not apply to any amount if interest is required to be paid on such amount or if there is any penalty for failure to timely pay such amount. The "nonaccrual-experience" treatment provided in section 448(d)(5) is a method of accounting that must be elected by the taxpayer. Sec. 1.448-2T(b), Temp. Income Tax Regs. As stated above, [REDACTED] currently has no evidence available to prove it made an election to use this method of accounting as required by the regulations under section 448. See Sec. 1.448-2T(h)(3), Temp. Income Tax Regs.

Section 162 of the Internal Revenue Code allows a deduction for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Generally, the timing of the deduction for an expense that meets the requirements of section 162 is determined under section 461.

Treas. Reg. § 1.461-1(a)(2)(i) provides, in part, that under an accrual method of accounting, a liability is incurred and generally is taken into account for Federal income tax purposes, in the taxable year in which: (1) all the events have occurred which fix the fact of the liability; (2) the amount of the liability can be determined with reasonable accuracy; and (3) economic performance has occurred with respect to the liability.

In United States v. General Dynamics, 481 U.S. 239 (1987), the Supreme Court framed the issue as whether an accrual basis taxpayer providing medical benefits to its employees may deduct at the close of the taxable year an estimate of its obligation to pay for medical care obtained by employees or their qualified dependents during the final quarter of the year, claims for which were not reported to the employer. The Claims Court and the Federal Circuit had held that all events which determined the fact of liability occurred when the eligible employee received covered medical care. The Supreme Court reversed and stated that the case involved a mere estimate of liability based on events that had not occurred before the close of the taxable year, and the all events test was not met; the missing event in order to fix liability was the filing of properly documented claims forms. The Court explained, "[i]t is fundamental to the 'all events

test' that, although expenses may be deductible before they have become due and payable, liability must first be firmly established. This is consistent with our prior holdings that a taxpayer may not deduct a liability that is contingent Nor may a taxpayer deduct an estimate of an anticipated expense, no matter how statistically certain, if it is based on events that have not occurred by the close of the taxable year." 481 U.S. at 243.

In General Dynamics, the Supreme Court further explained that the fact that "General Dynamics may have been able to make a reasonable estimate of how many claims would be filed for the last quarter does not justify a deduction," 481 U.S. at 245, in pertinent part, as follows:

In Brown [v. Helvering], 291 U.S. 193, 201 (1934)], the taxpayer, a general agent for insurance companies, sought to take a deduction for a reserve representing estimated liability for premiums to be returned on the percentage of insurance policies it anticipated would be cancelled in future years. The agent may well have been capable of estimating with a reasonable degree of accuracy the ratio of cancellation refunds to premiums already paid and establishing its reserve accordingly. Despite the 'strong probability that many of the policies written during the taxable year' would be cancelled, 291 U.S., at 201, 54 S.Ct., at 360, the Court held that 'no liability accrues during the taxable year on account of cancellations which it is expected may occur in future years, since the events necessary to create the liability do not occur during the taxable year.' Id. at 200, 54 S.Ct., at 359. A reserve based on the proposition that a particular set of events is likely to occur in the future may be an appropriate conservative accounting measure, but does not warrant a tax deduction. . . .

481 U.S. at 246.

With regard to pending sales that failed to close, [REDACTED]'s "liability" was not fixed until there was, at a minimum, a default by a party to the sales transaction. Therefore, for tax purposes, [REDACTED]'s accrual for uncollectible commissions was premature. The deduction taken was simply for establishing a reserve which is not permitted absent specific statutory provisions permitting a deduction for a reserve. Brown v. Helvering, 291 U.S. at 201-202; World Airways, Inc. v. Commissioner, 62 T.C. 786, 801 (1974), affd. 564

F.2d 886 (9th Cir. 1977).²

With the rendition of this advice, we are closing our file. Please contact the undersigned at telephone number [REDACTED] if you have any questions or comments concerning the foregoing.

[REDACTED]
Attorney

²See Spitzer Columbus, Inc. v. Commissioner, T.C. Memo. 1995-397.